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ORIGINAL

BEFORE THE ARIZONA CORPORATI

Jeff Hatch-Miller
Chairman
William A. Mundell
Commissioner
Marc Spitzer
Commissioner
Mike Gleason
Commissioner
Kristin Mayes
Commissioner

IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	**Docket No G-0155A-04-0876**

NOTICE OF FILING TESTIMONY

Pursuant to the Amended Procedural Order in this matter issued on March 10, 2005, the Arizona Utility Investors Association (AUIA) hereby provides notice that it has filed the direct testimony of Walter W. Meek.

Respectfully submitted, this 26th day of July, 2005.

Walter W. Meek

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the foregoing testimony filed this 26th day of July, 2005, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the foregoing testimony hand delivered
this 26th day of July, 2005, to:

Jeff Hatch-Miller, Chairman
William A. Mundell, Commissioner
Marc Spitzer, Commissioner
Mike Gleason, Commisioner
Kristin Mayes, Commissioner
Christopher Kempley, Esq., Legal Division
Jane Rodda, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division

A copy of the foregoing testimony was
mailed this 26th day of July, 2005, to:

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All Parties of Record

Walter W. Meek

DIRECT TESTIMONY OF WALTER W. MEEK

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA"), a non-profit organization formed to represent the interests of equity owners and bondholders who are invested in utility companies that are based in or do business in the State of Arizona.

Q. DOES AUIA'S MEMBERSHIP INCLUDE SHAREHOLDERS WHO HAVE EQUITY INTERESTS IN SOUTHWEST GAS CORPORATION (SWG)?

A. Yes. AUIA'S membership has always included owners of the common stock of Southwest Gas Corporation.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. On behalf of AUIA, an intervenor in this proceeding.

Q. CAN YOU SUMMARIZE YOUR EXPERIENCE IN REPRESENTING AUIA BEFORE THIS COMMISSION?

A. I represent the largest cross-section of utility stockholders in the State of Arizona and I have been involved with the utility business in Arizona for 30 years. I have been president of AUIA for 11 years and I have participated in dozens of Commission dockets on behalf of AUIA and testified in numerous proceedings. My testimony has covered topics including rate of return issues, stranded costs, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. ARE YOU TESTIFYING AS AN EXPERT WITNESS?

A. Not really. Although I believe that AUIA's positions are based on solid economic principles, I try to bring a "real world" investor perspective to some of the investment and regulatory issues raised in the application.

Q. HAS AUIA INTERVENED IN PREVIOUS SOUTHWEST GAS RATE CASES?

A. Yes. AUIA was a party to the company's 2000 rate case (Docket No. G-02552A-00-0309).

Q. CAN YOU SUMMARIZE AUIA'S POSITION REGARDING THE CURRENT SOUTHWEST GAS APPLICATION?

A. Yes. AUIA agrees with the company's assertion that it needs a significant increase in margin based on a competitive authorized rate of return in order to maintain its financial integrity. However, we are equally interested in some of the rate design principles that SWG has introduced in this case. AUIA believes that the Commission has an opportunity here to engage in some truly progressive ratemaking that melds the interests of SWG shareholders and ratepayers in an important national energy context.

Q. CAN YOU OUTLINE THE KEY SUBJECTS THAT YOU WILL COVER IN YOUR DIRECT TESTIMONY?

A. Yes. My testimony will cover four subject areas:

- I will discuss the company's perennial inability to earn a reasonable rate of return and the effect of that on the company's shareholders and customers.
- As a part of a necessary financial fix and a progressive rate design for

SWG, I argue for a mechanism to decouple the company's earnings from the volume of gas it sells, particularly to residential customers.

- Among potential solutions to the earnings dilemma, I will discuss the need to provide a rate design that assures recovery of the company's fixed costs, which is not occurring today.

- Finally, I will comment briefly on the revenue requirement advanced by the company, including its proposed return on equity (ROE) and overall rate of return (ROR).

2. SWG'S MEDIOCRE EARNINGS RECORD DAMAGES SHAREHOLDERS AND CUSTOMERS.

Q. WHAT IS THE COMPANY'S RECORD IN TERMS OF EARNINGS?

A. In the eleven years since the end of the company's 1992 rate case, SWG has earned its authorized rate of return only once, in 1998, which was a year with below-normal temperatures and above-normal heating-degree days. In the 2004 test year, the company's indicated overall rate of return was an abysmal 4.78 percent while its return on common equity (ROE) fell to 3.56 percent compared with its authorized ROE of 11.0 percent.

Q. WHAT IS THE EFFECT OF CHRONIC UNDER-EARNING?

A. I believe there are several negative impacts. Some affect the company and its shareholders and others extend to SWG ratepayers.

Q. WHAT ARE SOME OF THE IMPACTS ON SHAREHOLDERS?

A. The most obvious effect is that the loss of retained earnings reduces shareholder equity. SWG witness Robert Mashas testified that the 11-year shortfall between actual and allowed earnings exceeded $145 million. That is money that has simply been denied to the shareholders' side of the balance sheet. Furthermore, the stock of a utility that under-earns chronically and has a highly leveraged balance sheet will be assigned a higher degree of risk and most certainly will be undervalued by the financial markets. I believe that is the case with Southwest Gas.

Q. **WHAT ARE SOME IMPACTS ON THE COMPANY'S OPERATIONS?**

A. SWG's annual customer growth is well above the industry average in its three-state service territory. As a result, it is under constant pressure to access the capital markets to fund new infrastructure. As SWG witness Jeffrey Shaw testified, if the company had earned up to its potential, its balance sheet would be stronger and its long term debt would be less. Instead, the company's balance sheet is leveraged, at about 66 percent debt, and its credit metrics produce ratings that are barely investment grade, making it more expensive to borrow money. A company that operates on the edge financially is always in danger of falling into the purgatory of junk status and the severe limitations that come with that.

Q. **AND WHAT ARE SOME IMPACTS ON SWG CUSTOMERS?**

A. All of these impacts are interrelated and they eventually fall on the customers. Higher interest expense resulting from poor credit ratings is passed on to ratepayers. In addition, it could be argued that if $145 million of retained earnings could have been applied to long term debt, SWG ratepayers have been saddled with about $60 million of unnecessary interest payments at SWG's average cost of debt. Finally, it should be said that a company with anemic earnings and poor credit ratings is always at risk for negative events that could interfere with its ability to provide safe, reliable service to its customers.

Q. WHAT ARE THE POLICY IMPLICATIONS FOR CHRONIC UNDER-EARNING?

A. It is unacceptable public policy for a regulated utility to be unable to earn its authorized rate of return despite management's best efforts to control costs and operate efficiently. It is unfair to stockholders to be denied equity gains which are rightfully theirs and it is unfair to ratepayers to have to shoulder the burden of unnecessary interest costs and the risk of deteriorated service.

Q. IS SWG MANAGEMENT BLAMELESS FOR THIS CIRCUMSTANCE?

A. I can't provide an unqualified answer to that question, but the evidence indicates strongly that SWG has hammered relentlessly on the expense side of the earnings equation. The company has increased its ratio of customers to employees from 507 per employee in 1997 to 745 in 2004. Although that may not tell the whole story, any company that can improve its employee/customer efficiency by 47% in seven years, has a firm grip on its largest cost center.

Q. IN AUIA'S VIEW, WHAT ARE THE MAIN REASONS FOR THE EARNINGS GAP?

A. As I noted earlier, AUIA was an intervenor in the company's 2000 rate case. We predicted at the end of that case that SWG would be unable to earn the rate of return authorized in that decision. I believed then, as I do now, that the Commission's continued reliance on commodity sales to generate revenues and its failure to focus on fixed cost recovery are serious structural impediments to achieving adequate earnings.

3. <u>THE COMMISSION SHOULD DECOUPLE SWG EARNINGS FROM COMMODITY SALES.</u>

Q. WHAT IS THE ISSUE REGARDING COMMODITY SALES?

A. According to Mr. Shaw, residential customers make up 95 percent of SWG's customer base and the usage behavior of nearly all of them is weather sensitive. SWG's currently authorized rates are designed to recover 62 percent of the residential margin from commodity sales. The problem is that residential sales keep dropping on a per-customer basis.

Q. HOW SERIOUS IS THE DECLINE IN USAGE?

A. According to SWG witness James Caltanach, weather-normalized usage has dropped from about 556 therms annually per customer in 1986 to 347 therms in 2004, a decrease of 37.5 percent. Significantly, base load usage in mid-summer has fallen 39 percent. Recently, overall usage has dropped 10.7 percent since the 2000 case.

The fact that the overall comparisons are normalized for weather means that they don't account for winters that are warmer than average and which exacerbate the situation. Clearly, a rate design that relies on commodity sales in the face of declining usage puts the company's earnings seriously at risk.

Q. CAN THE DECLINE BE REVERSED?

A. That is not likely. First, the weather-normalized figures show that the downward trend is institutionalized in the marketplace, caused mainly by increased efficiencies in housing and appliances. In other words it's not a fad or a reversible trend. In reality, rapid growth served by new housing stock simply assures that the downward trend will continue. Second, Mr. Caltanach demonstrates that there is measurable price elasticity in gas sales and my point would be that prices are not going anywhere but up in the foreseeable future.

Q. **WHERE DO CONSERVATION RATES AND PROGRAMS FIT IN?**

A. Conservation is a mixed bag. On the one hand, efficient use of any energy resource is a laudable goal. Furthermore, there is no question that the national interest is served by controlling the demand for natural gas. I would argue, however, that controlling demand in today's market, other than through price elasticity, would be accomplished better by conserving electricity than by forcing homeowners to turn down their gas thermostats.

Conservation rates should not be punitive or coercive; that is, they should not penalize me as a customer because certain choices aren't available to me, nor should they require me to make choices that are economically inefficient.

In any event, it makes no sense to hitch a utility's margin recovery to the volume of commodity sales and then pile on a conservation rate that is designed to curtail consumption even more than is already occurring in the marketplace.

Q. **WHAT IS THE SOLUTION TO THIS DILEMMA?**

A. The company has proposed a mechanism -- a Conservation Margin Tracker (CMT) -- to uncouple the utility's margin recovery from gas sales volumes which are subject to consumption variables, including weather. AUIA supports this proposal.

Q. **HOW WOULD THE CMT WORK?**

A. As I understand it, the Commission would authorize a residential margin level, which would be tracked through the CMT. If margin recovery varied from that which was authorized, the difference would be deferred and applied to customers' bills over a specific time period, either as a surcharge or as a credit.

Q. **WHAT ARE SOME BENEFITS OF THIS PROPOSAL?**

A. Depending on the details, it could remove much -- but not all -- of the uncertainty in achieving authorized rates of return by reducing the company's dependence on gas sales. It is very likely that a workable mechanism would improve the company's mediocre credit profile and could lead to better treatment from the rating agencies. The CMT would mitigate the obvious conflict between conservation efforts and SWG's revenue needs.

Q. **IS THIS A REVOLUTIONARY PROPOSAL?**

A. It is progressive, but not revolutionary. The natural gas industry and the nation's utility regulators have recently endorsed the idea of decoupling earnings from sales and three states have adopted such mechanisms. As SWG witness Steven Fetter testified, the American Gas Association (AGA) and the Natural Resources Defense Council (NRDC) led the way in July 2004 with a joint statement supporting rate true-ups "to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales."

Q. **WHAT HAVE REGULATORS DONE?**

A. At its summer session in July 2004, the National Association of Regulatory Utility Commissioners (NARUC) considered the joint statement of AGA and NRDC and the NARUC board of directors adopted a resolution encouraging state commissions to consider the ideas presented in the joint statement. In addition, three state commissions -- Oregon, California and Maryland -- have adopted varying mechanisms to decouple margin recovery from the vagaries of gas sales.

Q. COULD THIS BE CALLED A TREND?

A. It will probably vary with circumstances, but I met last week with a senior official of AGA who told me that a number of gas utilities are preparing rate cases to bring this issue to the table and that a number of jurisdictions will be giving it serious consideration. He said, "You can tell your Commission that they won't be alone if they give this idea a chance."

4. <u>THE COMMISSION SHOULD INCREASE THE COMPANY'S BASIC SERVICE CHARGE.</u>

Q. WHAT IS AUIA'S CONCERN REGARDING RECOVERY OF FIXED COSTS?

A. Since gas distribution companies have given up any profit interest in the gas commodity, the vast majority of company expenses are, in reality, fixed costs. The Arizona Corporation Commission has been slow to recognize this reality and SWG has no assured method of recovering the majority of its fixed costs.

Q. HOW SEVERE IS THE PROBLEM AT SOUTHWEST GAS?

It is quite severe. As Mr. Shaw testified, SWG's current residential rate design recovers only 38 percent of those costs through its basic service charge. The rest is relegated to the company's commodity charge and we have already demonstrated that commodity sales are an unreliable and contradictory source of cost recovery. The status quo is not appropriate if the Commission has any concern about the company's financial integrity.

Q. WHAT IS THE IMPACT ON THE COMPANY'S FINANCES?

A. From the standpoint of the investment community and the credit rating agencies, a company's inability to recover its fixed costs on a reliable and timely basis would be a serious weakness that would be reflected in elevated risk assessments and weak credit profiles. I believe that is true of SWG.

Q. HAS THE COMMISSION IGNORED THIS ISSUE IN THE PAST?

A. No. In the company's last rate case, the Commission authorized an increase in the basic service charge from $5.50 per month to $8.00, an increase of 45 percent. This was not insignificant, but it was not enough in 2004 and is well short of what is needed today.

Q. WHAT IS APPROPRIATE TODAY?

A. The company has proposed that its basic service charge be raised from $8.00 per month to $12.00, a 50 percent increase, if the CMT is adopted and a 100 percent increase, to $16 per month, without the CMT. Even this level of increase would not assure full recovery of fixed costs. AUIA supports these increases as reflective of the company's needs and the activity in other jurisdictions.

Q. ARE OTHER JURISDICTIONS TACKLING THIS ISSUE?

A. Apparently so. AGA reports that more productive fixed cost recovery mechanisms are under consideration by many state commissions. This is in response to utility financial imperatives and the desire to reduce reliance on commodity sales to achieve authorized margins.

Q, IS THE SWG PROPOSAL OUT OF LINE WITH OTHER JURISDICTIONS?

A. No. According to AGA, several cases involve higher levels of basic service charges than SWG has proposed in this proceeding. For example, I was in North Dakota a week ago in meetings at Montana Dakota Utilities (MDU) and that company reported that the North Dakota commission had just granted an increase in its basic service charge from about $5.00 per month to nearly $15.00, a 200 percent increase.

Q. IS THE MDU INCREASE MEANT TO ADDRESS A SIMILAR PROBLEM?

A. Yes. Although I am waiting for information regarding the expected percentage of cost recovery, MDU executives said their objective is to recover their fixed costs more reliably and efficiently than they have in the past.

Q. SHOULD THE COMMISSION CONSIDER ADOPTING BOTH A HIGHER BASIC SERVICE CHARGE AND THE CMT?

A. Yes. SWG witness Edward Gieseking appears to offer the higher service charge increase as an alternate to the CMT, but we believe that both approaches are appropriate. Clearly, the Commission should be moving toward cost-based rates and that is what the service charge component represents. In our view, some movement in that direction is necessary. At the same time, it seems obvious that the rate design will contain a commodity sales component for the foreseeable future and that component should be subject to the CMT.

Q. IS THE PROPOSAL TO INCREASE THE BASIC SERVICE CHARGE COMPATIBLE WITH ADOPTING THE CMT?

A. Yes. The two proposals are complimentary within the overall strategy of enabling the company to earn a larger and more acceptable portion of its authorized rate of return. The portion of costs that is not recovered through the basic service charge would be allocated to commodity sales, but would be subject to correction through the CMT.

5. <u>SOUTHWEST GAS REQUIRES A WORKABLE CAPITAL STRUCTURE AND AN ADEQUATE RATE OF RETURN ON ITS INVESTMENT.</u>

Q. **HAVE YOU FORMED AN OPINION ABOUT THE COMPANY'S PROPOSED CAPITAL STRUCTURE?**

A. Yes. I agree with company witness Thomas Wood's analysis, which recommends a hypothetical capital structure that produces a common equity component of 42 percent compared with the company's actual equity ratio of 34.1 percent.

Q. **WHY IS A HYPOTHETICAL CAPITAL STRUCTURE IMPORTANT?**

A. The key is the response of the credit rating agencies. As Mr. Wood points out, SWG currently suffers with credit ratings that are barely investment grade and it must compete for investment capital with other gas distribution companies that have lower risk profiles, healthier balance sheets, better earnings, stronger interest coverages and, therefore, higher ratings than SWG. One of the three rating agencies, Moody's Investor Services, currently has SWG on negative outlook.

Q. **HOW DOES A HYPOTHETICAL CAPITAL STRUCTURE HELP?**

A. In the short term, the objective is to prevent any deterioration in the company's credit quality because there is no room for it. A capital structure for ratemaking purposes that approximates that of a higher rated company is potentially attractive to the rating agencies. The structure proposed by Mr. Wood is similar to that of a company rated BBB in Standard & Poor's rating scheme and should help to insulate SWG from negative consequences.

Q. **WOULD THIS STRUCTURE PLACE A BURDEN ON RATEPAYERS?**

A. I concur with Mr. Wood that the difference in the equity component between the actual and hypothetical capital structures is not large enough to be a burden to ratepayers. I believe a potential deterioration in the company's credit ratings could be more damaging to ratepayers.

Q. HAVE YOU FORMED AN OPINION ABOUT THE COMPANY'S PROPOSED RATES OF RETURN?

A. Yes. To recap, Mr. Wood's overall rate of return of 9.40 percent depends, not only on his hypothetical capital structure, but on the cost of equity component of 11.95 percent recommended by SWG witness Frank Hanley. I believe both are reasonable under the circumstances.

Q. WHAT CIRCUMSTANCES ARE YOU REFERRING TO?

A. As the Commission knows, I am an advocate for basing rate-of-return decisions on real world circumstances in lieu of academic formulas. I am also a disciple of the standards set out in the *Bluefield Water Works* and *Hope Natural Gas* cases, which require that a utility's return must be sufficient to support its financial requirements and that investors must be given an opportunity to earn a return that is comparable to returns on investments in other enterprises having corresponding risks.[1]

In this instance, SWG exhibits far more risk than the comparable gas utilities cited by Mr. Hanley, all of which have better credit profiles, higher ratings, healthier balance sheets, larger equity components and stronger interest coverages than SWG and are probably growing more slowly. In addition, the two groups of proxy companies achieved average ROEs of 12.11 percent and 11.7 percent during his study period, while SWG earned only 6.74 percent in Arizona.

Q. HOW SHOULD THESE CIRCUMSTANCES AFFECT THE ROE?

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[1] See Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), and Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944)

A. SWG's authorized ROE should reflect the additional risk that this company presents to investors compared with its peers and it should reflect what is being achieved in the marketplace by comparable entities.

Q. HOW IS THE CMT FACTORED INTO THE RECOMMENDED ROE?

A. Mr. Hanley's recommendation of 11.95 percent ROE assumes that the company will receive no protection in rate design from declining consumption. However, he estimates that the value of the CMT, if adopted, is approximately 25 basis points, which would reduce the recommended ROE to 11.7 percent. That, in turn, would lower the proposed overall rate of return to 9.29 percent.

6. <u>CONCLUSION</u>

Q. DO YOU HAVE SOME CONCLUDING REMARKS?

A. Very briefly. It has been shown clearly that Southwest Gas has failed consistently to earn its authorized rate of return due to the failure of its approved rate design to provide fixed cost recovery and to provide protection from declining customer usage.

This earnings gap has penalized consumers with higher or unnecessary interest costs and has plunged the company to the bottom of the barrel in terms of credit quality and almost any financial comparison with comparable gas distribution companies.

The Commission has an opportunity in this case to allign shareholder and customer interests through progressive ratemaking. But let me be blunt: If the Commission is unwilling either to focus on fixed cost recovery through the basic service charge or to adopt a mechanism to uncouple earnings from gas sales, Southwest Gas will remain at the bottom of the financial barrel for the foreseeable future.

AUIA urges the Commission to respond positively to help elevate Southwest Gas to a higher level.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.